Abbey and St Ann's Mills Kirkstall

Review of Report to Executive Board 15 December 2004

10 May 2006

KPMG LLP

Contents

1 Executive Summary

The findings in this report stem from a review of the Development Department's original report submitted to the Executive Board on 15 December 2004 regarding the future usage of Abbey and St Ann's Mills in the Kirkstall ward of Leeds. The report to the Executive Board was to make proposals regarding the refurbishment/remodelling of Council property at Abbey and St Ann's Mills, to assist in the regeneration of the Kirkstall Valley. The two sites currently provide Small Industrial Units (SIUs) for new and small businesses.

The Executive Board report was drafted with the intention of seeking additional resource to more fully understand the financial and non financial implications of the options. It was not seeking to finalise plans for development of Abbey and St Ann's Mills but rather to explore the opportunities which these sites presented to the Authority. However, given that a conclusion and recommended course of action is included in the report, the information which supports this recommendation should be as accurate and clear as possible and presented at an appropriate level of detail.

From our review we have the following positive observations:

- The option appraisal methodology employed was thorough in assessing the potential usage for both sites for an Executive Board report. The four options were clearly stated and assessed against a number of objectives all of which were detailed clearly in the report. The format of the report followed the Authority's capital options appraisal methodology which is detailed in the capital strategy and asset management plan.

- Each option was assessed and the positive and negative aspects were stated in a clear format and summarised in a decision matrix incorporating financial and non financial implications of each option. This matrix can be seen in Appendix 1.

- The financial implications of the options were considered using a Discounted Cash Flow (DCF) to give a Net Present Value (NPV) for each option in turn. This is an appropriate tool for assessing a capital project's long term financial standing.

- Issues specific to these sites were also raised and commented upon in the report. Issues explored included tenant hold over at St Ann's Mill whereby a major tenant was legally responsible for repairs to the unit under the terms and conditions of the lease, vesting of land whereby Leeds North West Homes (ALMO) have an interest in the treatment of land at Abbey Mill and the treatment of 649 Kirkstall Road a small, Authority owned property which had been unoccupied for 13 years and has since been demolished.

- The alignment with corporate objectives is addressed in the report through reference to the Authority's Capital Programme and wider issues such as the impact of the Disability Discrimination Act (DDA) are also considered in the report.

- The report made it clear to the reader that an objection had been received from a Member of the Kirkstall Ward. The Executive Board report contained a description of the alternative proposal. The reasons why it was not considered in the same detail as the four short-listed options was also included in the Executive Board report.

However, we also draw to your attention the following matters arising in our review:

- The report is unclear regarding what is being recommended in regard to the redevelopment of the St Ann's Mills site. No explicit mention is made of managed work space accommodation but the DCF appears to assume that this would be the preferred usage given the future rental roll assumptions. On the contrary, the Executive Board report states as an advantage that the preferred option would maximise 'capital receipts for re-investment in SIUs in Kirkstall' contradicting the suggestion within the DCF detailed assumptions.

- Although the use of a DCF model was appropriate as a tool for assessing the project, there were a number of mathematical inaccuracies, inconsistencies between the narrative of the report and financial information contained in the detail of the DCF model and a lack of clarity in other areas. These combined mean that the financial information reported to the Executive Board was incorrect and potentially misleading. Although the assumptions within the DCF contain a number of estimates which is a function of the long term nature of the project, these assumptions where possible and appropriate should be consistent between the options appraised and explained through working papers supporting the DCF. Whilst consistency was found between the body of the Executive Board report, the DCF and where relevant third party evidence such as surveyors' reports for some of the assumptions, this was not the true for many areas of the DCF. Observations in relation to the DCF model are detailed in the body of this report in Section 7.

- The inconsistencies within the report and between the report narrative and the DCF model also make it difficult to determine the exact nature of what is being recommended in terms of the development under each option. This would not be obvious to the reader of the report as only the headline NPV of each scheme is reported. This in itself is not a criticism as an Executive Board report would not be expected to detail all assumptions in the DCF model. However, given that only the headline result of the DCF is reported this means that the accuracy of the information incorporated in this model is fundamental as the assumptions are not open to scrutiny by the reader.

In summary, the Development Department's report in respect of Abbey and St Ann's Mills demonstrates the use of a thorough option appraisal methodology. The four options assessed in the Executive Board report were stated with clarity and appropriate tools were used to assess the viability of each proposal against financial and non financial criteria for a prospective development of this size. The focus of this review was largely financial in nature and therefore scrutinised the DCF model and the assumptions adopted regarding significant cash flows such as capital expenditure, capital receipts, maintenance charges and rental roll amounts. Our review highlighted inconsistencies between amounts included within the narrative section of the Executive Board report and the DCF assumptions. Substantial arithmetical errors in the DCF model used assess the financial standing of each proposal were also apparent.

However, although no attempt has been made to remodel the DCF in full, if following correction for arithmetical errors, the two highest scoring options are further adjusted for the apparent anomaly in maintenance charges, **the option championed by the Executive Board report still results in the highest NPV**. The financial difference between option two and option four is becomes marginal, if amended, amounting to £46k over the lifetime of the project all other factors being equal. If the increased annual rental rates under option four were realised at only 98.5% of the anticipated level from period five onwards i.e. £267k as opposed to the predicted £271k, options two and four would be reversed in terms of their NPV result. No attempt has been made to model such risk factors and their potential impact in the Executive Board report. If the financial attractiveness of options two and four was marginal, non-financial aspects would be the deciding factors. The decision matrix in the Executive Board report (appendix one) suggests that option four would be favoured on this basis.

The purpose of the Executive Board report was to free resource to enable further investigation of the option being championed by the Development Department. Significant errors, predominantly in the DCF, should have been discovered through review and scrutiny. The magnitude of the errors found suggests a lack of internal review before presentation to the Executive Board. It is not our role to speculate whether the errors identified would have changed the decision arrived at by the Executive Board; however in the light of our findings we recommend that the Directors of Development and Corporate Services critically review the results of the DCF. Any revised report should incorporate any viable options that have come to light since the original report was issued on 15 December 2004.

2 Introduction

2.1 Background to investigation

A report was submitted by the Development Department to the Executive Board regarding Abbey and St Ann's Mills in Kirkstall on the 15 December 2004. The purpose of the report was to make proposals regarding the refurbishment/remodelling of Council property at Abbey and St Ann's Mills, so as to assist in the regeneration of the Kirkstall Valley. The two sites currently provide Small Industrial Units (SIUs)

The report concluded that mainline capital was unlikely to be made available to enable the units to meet the requirements of modern day start-up businesses and meet the specification set by the Development Department including compliance with Health and Safety Standards and Disability Discrimination legislation. The preferred option was to dispose of the more valuable Abbey Mills site and to re-invest the proceeds at St Ann's Mill.

The three Kirkstall Ward Members were briefed on the proposals. Two Members were reported as being in favour of the 'broad thrust' of the proposals subject to a number of caveats such as having ample time to comment upon the detailed plans for the site which were to follow the development departments report to the Executive Board.

One Member did not support the proposals, objecting to both the Abbey and St Ann's Mills elements of the proposal and the demolition of 649 Kirkstall Road. An alternative proposal was forwarded by this Member which is examined in more detail in section 3.5.

The Development Department's report was called in for review by Scrutiny on 10 January 2005 and it was unanimously agreed that the Executive Board decision should be immediately released for implementation.

However, following allegations of inaccurate and incomplete information being included in the report to the Executive by the opposing Member, an internal audit review was implemented. This primarily considered the accuracy of information in the Executive Board report and whether the costing information reported could be substantiated.

Internal audit concluded that although there were areas of the Executive Board report which could have been expressed with a greater degree of clarity, the 'report was reasonable and accurately reflected the information held at the time.' It is expressly stated in the Internal Audit report that the purpose of the report is to seek approval to undertake additional work that will give more accurate detailed costing. Broadly, Internal Audit concluded that the report was fit for the purpose intended.

The matter has since been referred to KPMG as external auditors to the Authority as dissatisfaction was expressed in the timing and content of the Internal Audit report. The complainant states that internal audit took approximately eight months from the time of registering the complaint to the Monitoring Officer to the point when a copy of the Internal Audit report was received. A review of Internal Audit's correspondence demonstrated that the report was finalised approximately five months after receiving a request for an investigation. The complainant also stated that there was little opportunity to consult with the Internal Audit department which meant that the audit investigation did not focus on the principal matters of complaint.

To date neither Abbey nor St Ann's Mills have been redeveloped or sold although 649 Kirkstall Road has been demolished as recommended. This was a small, Authority owned, detached house dating from the late nineteenth century. It had been unoccupied for 13 years and been severely vandalised. The reasons behind the demolition are reported in more detail in section 3.5.

2.2 Scope and objectives

The following terms of reference for this review were agreed with the complainant in December 2005:

- The inception of the option appraisal undertaken in the report to the Executive Board will be reviewed considered and in particular how the four final options which were considered were short-listed; and

- The accuracy of information included within the Executive Board report will be considered. This includes assumptions regarding rental income for the SIUs, backlog maintenance and DDA cost estimates, proposed capital receipts from the sale of the properties in question and the accuracy of the Discounted Cash Flow (DCF) model used, in part, to aid decision making.

This report focuses exclusively on information relating to or incorporated in the Executive Report of 15 December 2005. Although the option appraisal methodology is considered broadly in this report our primary focus was on the financial aspects of the option appraisal and including the DCF. At the time of agreeing the terms of reference the above areas represented the primary focus of the complainant.

2.3 Audit approach

Our audit approach has been to:

- Interview various members of the Development and Finance Department who were involved in the preparation of the report submitted to the Executive Board;

- Liaise with Internal Audit to obtain access to source documentation used in the original report to the Executive Board on 15 December 2004; and

- A site visit was undertaken with a senior surveyor from the Development Department on 13 December 2005.

2.4 Acknowledgments

We would like to take this opportunity to thank all the officers who supported this study

3 Option Appraisal

3.1 Introduction

Section 3 of the report to the Executive Board stated that due to the Authority having no other sites available in the Kirkstall area suitable for the reprovisioning of the SIUs the Authority was presented with the following options:

- Make available £2m of Capital Programme resources and retain/refurbish both sites for SIUs;
- Dispose of both sites and use capital receipts to support the mainline Capital Programme;
- Dispose of St Ann's Mills and re-invest the capital receipts in Abbey Mills; or
- Dispose of Abbey Mills and re-invest the capital receipts in St Ann's Mills.

Each option was appraised against a number of objectives (listed in section 3.2 of the Executive Board report) which in combination should ensure the maximum benefit for the regeneration of the Kirkstall Valley. Broadly, the process for appraisal was to first analyse each option in terms of advantages and disadvantages against set development criteria then the financial implications of each option were appraised using a DCF model. A preferred option became clear through this process and was then subject to further financial scrutiny, review by Members of the Kirkstall Ward and then scored against the Authority's Capital Scoring Matrix as described in section 3.3.

Key factors considered were both financial, such as backlog maintenance costs and rental income assessments which are addressed later in this report and non financial. Non financial objectives include the ability of each option to create and protect jobs, how complimentary each option would be to the Kirkstall Valley proposals and the extent to which the Authority retains control.

Option four was recommended on the basis that it satisfied the greatest number of the schemes objectives. This is clearly demonstrated in the option appraisal matrix included in section 3.7.1 of the Executive Board report. From the matrix it would appear that all objectives are given equal weighting in the decision making process although this is not explicitly stated.

3.2 Do nothing option

The Executive Board report did address the possibility not redeveloping the sites at Abbey and St Ann's Mills. This was addressed in terms of the risks that failing to invest would pose to the Authority:

- Non-compliance with DDA legislation would mean equality status degradation;
- The sites would become an increasing risk in terms of health and safety;
- The units would become increasingly difficult to let which would impact on the rental roll; and
- There would be no contribution to the regeneration of the Kirkstall area which was cited as the primary reason for the proposed scheme.

3.3 Other Appraisal Methods Utilised

Following the outcome from the initial option appraisal the scheme was also considered against the Authority's Capital Scoring Matrix which has been approved by the Executive Board. The matrix is a tool for ensuring that potential schemes meet the minimum required standard for inclusion in the Authority's capital programme. It is essentially a gateway system whereby if a potential scheme fails to meet the minimum criteria it is rejected. Option four scored 140 which is over and above the minimum level of 110 and would therefore eligible for inclusion capital programme. Although, this demonstrates attention to detail in the appraisal system, if acceptance of an option in the capital programme was a binding factor this should have been a condition in the original decision matrix in section 3.7.1 of the Executive Board report. The results of option one and three were not included in the Executive Board report.

3.4 Consultation

The three Kirkstall Ward Members were briefed on the proposals and subject to a number of caveats, were reported in general terms as supportive of the scheme. The caveats are stated in clear terms and adequate detail in the Executive Board report.

3.5 Alternative Proposal

Although a critique of the alternative proposal for the development of these sites forwarded by Councillor Illingworth is outside of the scope of this report, the way in which it is represented within the Executive Board report was considered.

Councillor Illingworth proposed the following:

- Retention of both Abbey and St Ann's Mills;
- Part disposal of units to existing tenants at Abbey Mills and to develop a mixed economy solution on that sites;

- Seek to relocate St Ann's Mills tenants and use the three storey mill building (unit six) to house local community groups, perhaps paying market rents; and

- Retain 649 Kirkstall Road for community use.

This was clearly reported in section 8.1 of the Executive Board report. However, the proposals were excluded from consideration in the same detail as options one to four. This was primarily due to the following reasons:

- The condition of the buildings is not addressed;

- No department within the Authority was willing to sponsor the proposed scheme;

- Very little capital would be raised; and

- Revenue demands from community groups would increase and the problem of poorly funded community groups in poorly maintained and inappropriate buildings would be exacerbated.

- 649 Kirkstall Road represented a health and safety risk in its current state so inaction was not deemed an option. The Executive Board report states a refurbishment cost of approximately £150k and poor vehicular access as reasons why this property was not marketable. Although, no evidence to substantiate this estimate was reviewed as part of this report the fact that the property has been unoccupied for 13 years would suggest that it was in a poor condition and would require significant maintenance work.

Again, the reasons for rejection of this proposal were clearly reported to the Executive Board. Furthermore, through consultation with the Chief Asset Management Officer it was evident that there was no sponsoring department within the Authority for any such scheme and there had been no applications from the voluntary sector for use of these sites. The lack of a sponsoring department was not expressed in the Executive Board report. If included, it would have strengthened the case for rejection of this alternative proposal.

3.6 Consistency with the Authority's Capital Projects Appraisal Methodology

The Authority has developed a corporate methodology within the Development Department aimed at complex or costly schemes (in excess of three million pounds). The methodology is set out in two parts and guides the user through a series of logical steps. The first part examines the business need driving the project, how the project fits into the Council's strategic framework and the overall objectives of the proposal. Once the key criteria for a solution to the business need are established, the process moves to the options available to provide this solution. This methodology should ensure that a balanced decision is reached.

The process then moves to the quantification and assessment of the costs and benefits for the available options. This may include non financial factors which by their nature cannot or are difficult to quantify but which need to be considered in reaching any decision. By reviewing the options in this way the development department are able to critically analyse the available options and derive the preferred solution.

In terms of the appraisal of the Abbey and St Ann's Mills schemes the above methodology was applied. The business need is detailed in section 2 of the Executive Board report and section 3 contains the option appraisal in terms of the financial and non-financial implications of each proposal. The preferred option is then elaborated in sections 4, 5 and 6 with final conclusions and recommendations to the Executive Board in sections 12 and 13 respectively.

The format of the report to the Executive Board follows the approach to the appraisal of capital projects which is detailed in the Authority's Asset Management Plan.

4 Rental income assumptions

4.1 Assumptions in the Executive Board Report

Rental income reported in the report has been considered for two reasons. Firstly, the current rental rolls give an indication as to the current market value and potential for letting these sites in their current state and secondly, future rental income assumptions have a material impact on the DCF model.

4.2 Current Rental Income

The Executive Board report states that the units at Abbey and St Ann's Mills are 37% and 83% occupied at the present time, with annual rental rolls of £21,500 and £20,500 respectively. At the time of the report there were eight small businesses employing 49 people. This position has deteriorated with one major tenant vacating the St Ann's Mill site. From the site visit, it is evident that units at both sites were in a poor condition.

The utilisation rate of Abbey Mills, as reported, was flagged as inaccurate by Internal Audit and should have been reported as 42.6%, and not 37%. This does not have a significant impact as this figure is independent from the rental roll which was taken from the Authority's ledger system. St Ann's two largest tenants, Chromogene and Farrington have vacated the premises where they previously occupied 54.4% of the floor area, which explains the poor utilisation rates.

4.3 Comparison with other Leeds City Council SIUs

The Authority currently have 13 small industrial estates in Leeds, providing workshop space for new and small businesses, most of them located within three miles of the city centre. Units range from 300 to 3,000 square feet.

In the period 6 April 2004 to 24 February 2005 the rental income for Abbey Mills totalled £22,800. This figure is not significantly different from the £21,500 reported in the Executive Board report. St Ann's Mill generated £18,976 of rental income in the period 6 April 2004 to 10 March 2005. Again, this is not materially different from the figure of £20,500 reported in the Executive Board report. Both differences have been caused by the fact that the information above was taken for the Authority's financial year ended 31 March 2005, whereas the Executive Board report had taken a different cut-off date due to it's publication date of 15 December 2004. However, the difference is not significant enough to influence the reader of the Executive Board report.

Information for rental income from the other SIUs owned by the Authority has been provided by the Development Department. The following table is a comparison between the rate being achieved at the date of the Executive Board report at the units at Abbey and St Ann's Mills and the rest of the Authority's portfolio.

Table 1

Site	**Area (sq ft)**	**Area rented (sq ft)**	**% occupied**	**Maximum annual rental roll***	**Annual rental roll (£)**	**Rent/sq ft (£)**
Abbey Mills	22,952	11,987	**42.53**	53,609	22,800	**1.90**
St Ann's Mills	28,185	19,257	**83.9**	22,628	18,985	**0.99**
All other units (excluding above)	257,544	198,359	**77**	1,184,619	912,157	**4.60**

* - Maximum annual rental is based on rent rates per square foot at the date the Executive Board report was presented.

This summary suggests that in their current state the demand for units at Abbey and St Ann's Mills is far less than for the rest of the Authority's portfolio and also that the rental rates achieved are substantially lower. Whilst on the site visit it was explained that the tenants were effectively paying 'ground rent' at St Ann's Mill due to the poor condition of the units.

The source of the above information is the Development Department's SIU database and the rental roll amounts have not been agreed back to the authority's ledger system, with the exception of Abbey and St Ann's Mills. The areas of each unit have also been taken from the database without third party verification. There is also evidence on the database showing that the occupancy dates in many cases are after the date of the Executive Board report's publication.

As this information is not included in the Executive Board report no additional verification of the SIU database has been undertaken as this data will be used only to assess the reasonableness of future assumed rental streams.

Although there are differences in the reporting period and rental rates between the database maintained by the Development Department and the Authority's ledger system, the current rental rates as reported in the Executive Board report were materially correct. However, the extremely low rental rates per foot and poor utilisation rates infer that the units at Abbey and St Ann's Mill are sub-standard when compared to the rest of the Authority's portfolio of SIUs.

4.4 Assumed Future Rental Rolls

Future rental income for the Abbey and St Ann's Mills is a key assumption within the DCF model that is summarised in the Executive Board report. These assumptions have been reviewed in section 7.1.6 of this report.

5 Capital Investment Assumptions

5.1 Introduction

From the site visit conducted on 13 December 2005, it was clear from a layman's perspective that both sites were in need of investment. Although this visit was undertaken a year after the Development Department submitted their report to the Executive Board, independent surveyor's reports contain photographic evidence which suggests that the state of the units was largely the same before the Executive Board report was issued on 15 December 2004.

The amount of capital investment reported for each site is a critical factor in the report impacting on the DCF model and the final NPV of each project. Given that capital is a finite resource at the Authority, the reports that the Executive Board receive should be accurate and transparent enabling officers and members to ensure that resources are employed in line with the Authority's strategic plans.

This section reviews the information contained within the Executive Board report in terms of the accuracy and clarity of the amounts anticipated to undertake the planned works at each site.

5.2 Backlog Maintenance Cost Variation

In terms of satisfying the option appraisal criteria the following reported objectives would be impacted by the level of investment required:

- Ability to address backlog maintenance on both site (section 3.2 (iii)); and
- Ability to support/fund public realm works on both sites (section 3.2 (iv)).

Table 2 below summarises the amounts of investment which are reported to the Executive Board for each of the sites:

Table 2

Nature of works assumed	**Executive Board report reference**	**St Ann's Mills**	**Abbey Mills**	**Total**
Backlog maintenance **including** Disability Discrimination Act (DDA) works	Section 2.6 and table 3.7.1	£433k	£626k	£1,059k
Backlog maintenance **including** Disability Discrimination Act (DDA) works	Section 2.7	Site cost not disclosed individually	Site cost not disclosed individually	£2,000k
Option 1 – refurbishment of both sites as SIUs	Section 3.9 (DCF results)	Site cost not disclosed individually	Site cost not disclosed individually	£2,502k
Option 3 - backlog maintenance work	Section 3.9 (DCF results)	N/a – site disposed	£1,493k	£1,493k
Option 4 - Refurbish Mill building	Section 6.1	£1,344k	N/a – site disposed	£1,344*

* This estimate of refurbishment works is taken from a section of the report which covers the financial implications of the preferred option. The refurbishment of St Ann's is reported as £1,200k; however it has been assumed that the fees at 12% would also apply to refurbishment works which would give a figure of £1,344k.

5.3 Clarity of Backlog Maintenance Costs Reported

The above table shows the inconsistencies between amounts reported as backlog maintenance costs within the Executive Board report and amounts that have been incorporated in the DCF model to derive the NPV of the options reported in section 3.9 of the Executive Board report.

This is either due to reporting error or a variation in the level of work anticipated. However, any variations in assumptions which would explain these differences are not outlined clearly in the Executive Board report. The Development Department have stated that any differences detailed in table two are due to taking a simplistic view of the figures quoted in the various reports reviewed. We acknowledge that an element of variation from the figures quoted in independent reports and the Executive Board reports would be expected and reasonable as officers applied their professional judgment and knowledge of the sites to the data obtained from third parties. The significant difference in cost between backlog maintenance including 'desirable' and 'long term' works and the cost of remodelling the sites as envisaged by the Development Department is not made clear to the reader and is not apparent from working papers available.

5.4 Independent Assessment of Backlog Maintenance Costs

Architectural Design Services (ADS) were commissioned by the Asset Management Unit of the Authority to undertake basic condition surveys of St Ann's and Abbey Mills. They in turn appointed Smithers Purslow (an independent firm) to assist in the survey. The site visits were both performed in Spring/Summer 2003. St Ann's Mills was visited on 22 and 23 July 2003 and Abbey Mills was visited on 28 - 30 July 2003. ADS were required to survey and examine the basic structure of the buildings, the electrical and mechanical services, asbestos content of the buildings, compliance with the DDA and other statutory requirements.

5.4.1 Abbey Mills Findings

The report concluded that with the exception of four of the units (two of which were 'vacant and derelict' and one being the toilet block) the SIUs were in 'reasonably sound structural order.' The report stated that the internal condition of all units were poor and extensive redecoration and localised refurbishment would be required to enable re-letting.

The following areas were noted as in need of improvement:

- The site boundaries require attention for impact damage and general deterioration;
- Although a number of roofs to the main building had been repaired in the last 18 months, the roof to unit three and the entire roof to unit 10/11 should ideally be replaced;
- Asbestos sheet roof coverings to the external store are in a poor condition and present health and safety and wind and weather-tight issues;
- The majority of the external timberwork is in poor condition and requires overhaul and refurbishment;
- Cracked stone lintels require replacement;
- DDA regulation compliance would also require a number of alterations and improvements across the site; and
- Heating, ventilation and the installation of modern toilet facilities were also raised as issues to address.

5.4.2 St Ann's Mills Findings

The report concluded that 'the buildings appear to be well utilised although, clearly, a number of internal refurbishments and external repairs to the building fabric are required to ensure that the buildings continue to be adequately functioning and in good structural order.' The main concern was cited as the upgrade of the existing electrical systems within unit six, the largest unit, due to 'their age and parlous condition.' Complete refurbishment at a significant cost was recommended. Other areas detailed as requiring attention included:

- Roofing to all units is in need of maintenance and repair, particularly units five and six where total replacement is recommended;
- Main walls to units show evidence of deterioration and internal walls are affected by penetrating and rising damp;
- Joinery repairs are needed to doors and windows and several cracked lintels require replacement;
- Asbestos issues are suspected following a survey of all units with annual inspections recommended going forward;
- To comply with DDA regulations the units would have to be adapted depending on each unit's size and usage; and
- Internal decoration and generally poor existing WC facilities would need to be addressed.

5.4.3 Budget Costing of Works

To comply with current legislation and to bring the building and facilities up to a good standard, certain works were detailed as being required. Estimates were provided on a unit by unit basis and in considerable detail. Repairs and maintenance were classified as ***imminent***, ***essential***, ***desirable*** or ***long-term***.

Although, no detailed definitions were given how costs met each of these criteria within either the Smithers Purslow report or the Executive Board report, presumably ***imminent*** and ***essential*** works would be required to bring the asset into a state where it could be re-let to tenants having satisfied current building, health and safety and DDA regulations. ***Desirable*** and ***long-term*** work although aspirational presumably are not critical to the site's ability to operate as SIUs.

The reports also detail expenditure in terms of:

- Wind and weather items;
- Health and safety items;
- DDA upgrades;
- Asbestos removal works;
- Improvements/refurbishments;
- Electrical services; and
- Mechanical services.

The following table shows the estimated costs for both sites as reported. The original estimates excluded VAT and professional fees. No estimates of VAT costs have been added but professional fees have been included at 12% to be consistent with the DCF model.

Table 3

	St Ann's Mills (£)	Abbey Mills (£)
Imminent	28,800	47,939
Essential	277,967	340,460
Desirable	87,688	124,161
Long-term	39,200	113,525
Sub-total	**433,655**	**626,085**
Fees (12%)	52,039	75,130
Total	**485,694**	**701,215**

From the table above the cost of completing all repairs and maintenance work for both units varies considerably with £485k and £701 k being reported for At Ann's Mills and Abbey Mills respectively. However, when ***imminent*** and ***essential*** works are compared in isolation, the difference is far less substantial. The estimate for works at St Ann's Mills of £343,579 (£306,767 + 12% fees), whereas a corresponding figure for Abbey Mills amounts to £435,006 (£388,399 +12% fees).

When combined, Abbey and St Ann's Mills ***imminent*** and ***essential*** works including fees amount to £779k. As previously stated, this presumably would bring the units back into a condition which would enable them to be re-let by the Authority as SIUs and would be consistent with option one which was to retain both sites as SIUs. The data from these reports (table 3) has been included in the Executive Board report in section 2.6 as detailed in table 2. There is clearly inconsistency between the £1,059k quoted for maintenance works in the Executive Board report and the ***imminent*** and ***essential*** works including fees amount to £779k. This difference would be further increased if 12% fees were added to the £1,059k quoted.

The Executive Board Report also fails to indicate the level of work assumed with the cost estimates provided with clarity as the amount included in section 2.6 of the Executive Board report includes a substantial amount for ***desirable*** and ***long-term*** works. The Executive Board report is unclear as to whether ***desirable*** and ***long-term*** works are necessary to bring the units to a state where they could be rented as SIUs as outlined in option one or whether they go beyond this level of refurbishment.

The Development Department state that ***desirable*** and ***long-term*** works were needed to avoid having to address these works within a few years of completing the ***imminent*** and ***essential*** works. This however would not be obvious to the reader and could have been expressed with greater clarity.

The Executive Board Report also implies that of the backlog maintenance works of £1,059k, a substantial amount of these relate to items which are of 'essentially wind, weather-tight and of a health and safety nature.' However, the survey found that these items would amount to £265k (excluding fees) or 25% of the total estimated cost. This may have been caused by variations in the definition of works within the condition survey report and the Executive Board report but again this is not made clear to the reader.

It should also be noted that the DCF model assumes capital costs of £2,500k in years one to five under option one which bear no relation to any of the figure detailed above. This is reviewed in more detail in section 7.1.3 of this report.

In summary, there is a wealth of information available detailing the nature of the backlog maintenance works needed for each unit at both Abbey Mills and St Ann's Mills site. However, the Executive Board report is unclear as to what is being recommended as part of backlog maintenance work and there are clear inconsistencies in the cost assumptions for these capital works between the narrative to the Executive Board report and the DCF model results reported within it.

6 Capital receipts

6.1 Capital Receipts

Capital receipts are a key assumption within the DCF model that is summarised in the Executive Board report. These assumptions have been reviewed in section 7.1.5 of this report.

7 Discounted Cash Flow Review

7.1 Discounted Cash Flow Results

A DCF exercise was completed as part of the Executive Board report's option appraisal to quantify the four potential developments in terms of their Net Present Value (NPV). It is important to note that that this was not the only tool used for analysis as quantitative and qualitative aspects of the schemes were also considered in a decision matrix as detailed in section 3.3 of this report. This summarised each of the four potential schemes in terms of whether they met budgetary and other softer objectives of the regeneration work as defined by the Development Department.

The Executive Board reports the following NPV results in section 3.9 for each of the four options under review:

Table 4

Option	Action	Net Present Value (£k)
1	Retain both sites	1,370
2	Sell both sites	2,040
3	Sell St Ann's, retain Abbey	2,200
4	Sell Abbey, retain St Ann's	2,910

The conclusion drawn from the both the DCF exercise and the decision matrix was that option four, namely disposing of Abbey Mills and reinvesting in St Ann's Mills was the best option. The Executive Board report states that the DCF result 'supports the choice of option four'. This suggests that the decision matrix was the driver behind the decision making and the DCF exercise was used to provide assurance that the decision made sense financially.

Option four as stated above gave the greatest return with a NPV of £2,910k. Option three which involved selling St Ann's and reinvesting in Abbey Mills gave the second best return of £2,200k. If the results of the NPV exercise showed that option four failed to deliver the greatest monetary return it ***may*** still have been championed as the preferred option on the basis of greater perceived qualitative value of the scheme as detailed in the decision matrix in section 3.7.1 of the Executive Board report and appendix one.

It is not possible to determine the weighting that the reader and decision maker has placed on the DCF but it should be factually correct and based on reasonable assumptions. Each option has been evaluated in terms of mathematical accuracy and the reliability of assumptions. Where possible, any inaccuracies have been quantified.

7.1.1 Mathematical accuracy

The most obvious error in terms of presenting this result is the fact that in section 3.9 of the Executive Board report the NPV of option one is quoted as a positive cash ***inflow*** over the period under consideration of £1,370k whereas when the model used to generate this result is reviewed the result is actually a cash ***outflow*** of £1,370k.

As this is the least favourable result anyway the impact on the reader is likely to be negligible.

Option three also contains a fundamental error as capital costs assumed in years one to five of £1,490k have been included as a cash ***inflow*** rather than a cash ***outflow***.

Considering these two items in isolation, if corrected a revised model was show the following results:

Table 5

Option	Action	Net Present Value (£k)
1	Retain both sites	(1,370)
2	Sell both sites	2,040
3	Sell St Ann's, retain Abbey	(561.8)
4	Sell Abbey, retain St Ann's	2,910

The two errors above, if corrected appear to strengthen the case considerably for option four but have a significant impact on reader of the Executive Report as the decision based on the financial outcome has changed from being between options three and four, to between two and four due to the significant cash outflow apparent under option three if the model is corrected.

Given capital constraints at the Authority, it is likely that the financial viability of the projects was a critical element of the decision making process. However, although such errors should have been identified through internal review before the report was taken to the Executive Board, the purpose of the report is to direct additional resource to enable further scrutiny of the preferred option before the final decision is made. Fundamental errors in the mathematical accuracy which presumably would have been identified at this stage with appropriate corrective action being taken.

7.1.2 Common Assumptions of Discounted Cash Flow

The DCF incorporates the following assumptions and applies them to all four options:

- Project term is 25 years;
- Interest rates are assumed at 3%;
- Discount rate used to account for the time value of money 3.5%;
- Building cost inflation 5%;
- Fees (engineering, architectural etc) 12%; and
- Asset management charges 2.5% per annum.

All the above assumptions were consistently applied to all four options and considered to be reasonable. The Executive Board Report did not make these assumptions known presenting the reader with the results of the DCF only. Given the intended audience for a report of this nature, it would be reasonable not to include all assumptions made in the DCF model.

7.1.3 Capital Costs

All options with the exception of option two have an assumed capital cost built into the DCF. Capital costs are significant as they are material in size and also impact on other cash flow assumptions such as the level of future rental that can be obtained. A number of cost estimates for these works have been obtained through external consultation and generated internally by the development department. It is not clear from information contained in the detailed DCF model which assumptions have been made regarding end use of a site and where the capital costs have been derived.

Option one for instance, states that there are capital costs of £2,500k in years one to five which equate to a net present outflow of £2,250k taking into account the time value of money. Rental rates double in the model following the apparent completion of the capital works in year five. Although not explicitly stated in the model and no workings have been given, the future rental rolls assumed indicate the continuation of the units as SIUs. This is plausible as the units at St Ann's and Abbey Mills are less than fully utilised (see section 4.3) and current rental rates have been driven below market value by the poor condition of the units.

The capital works would therefore be assumed to consist of backlog maintenance work and DDA compliance works required to bring the SIUs to a state of repair where they can be let commercially.

However, when documentation was sought to substantiate the capital spend modelled of £2,500k there were several different estimations from various sources. These are detailed in table 2 of this report in section 5.2 of this report.

Although backlog maintenance costs have been considered in detail in section 5, there is a lack of information within the DCF to enable the reader to assess the validity of the capital costs that are being reported. The extent to which backlog and maintenance work to bring the units up to the minimum standard to enable the SIUs to be let or whether they constitute a change in use is also unclear in the report. Although this detail is not required to be stated explicitly in the Executive Board Report it is needed to ensure credibility in the results of the DCF which are reported.

In summary, the Executive Board report contains a number of inconsistencies in respect of capital costs which impact on the DCF and therefore will have some impact on the decision making process. The reason for these inconsistencies is not clear and may be due to variations in the anticipated scope of work. However, the Executive Board report fails to explain these differences and no working papers were evidenced reconciling the capital costs reported in the body of the Executive Board report and amounts included in the DCF calculation.

7.1.4 Maintenance Charges and Asset Valuations

Maintenance charges are included in the DCF model at 2.5% of the value of the underlying asset. This is a standard charge in respect of planned revenue funded maintenance work in the Asset Management Plan. As all options with the exception of option two (sale of both units) include capital works and leave the Authority with a valuable capital asset these charges can be substantial over the 25 life of the DCF model and have a significant impact on the resulting NPV.

Option one has an annual maintenance charge of £50k from year six onwards. The model therefore assumes that there is no underlying asset value for St Ann and Abbey Mills until the capital work has completed. This conflicts with the independent surveyor's opinions which are considered in more detail in section 7.1.5 and with the fact the model assumes rental income in the period up until the capital works are complete. Common sense dictates that if there are tenants in the SIUs then there will be a corresponding maintenance charge.

If the maintenance charges were included from year one this would have a £250k impact on the model or a reduction in NPV of £204.8k over the lifetime of the project. This also highlighted an arithmetical error in the DCF model. The discount rate in option one had been applied on maintenance charges as if period six were period one as there were no cash flows of this type in option one until period six. The true NPV of this outflow should have been £619.3k rather than the reported £710.6k.

The maintenance charge of £50k in option one is based on a valuation of both sites at a combined total of £2,000k. This is materially consistent with the figures stated in sections of the Executive Board Report, specifically section 3.4.1 states that 'sale of the two sites might realise a figure in the region of £2,025k.'

Although there are issues in terms of the maintenance charges raised in option one greatest impact of the reported maintenance charges in respect of the reader of the Executive Board report are the charges levied on options three and four, the two most financially attractive options. The maintenance charge on both options starts once the capital works have been completed and are therefore subject to the same observation noted above in that these should be recognised from year one.

Option three assumes that the site value is £1,650k giving a maintenance charge of £41.25k per annum. This is significant as it results in a cash flow of £825k (£586.3k NPV) over the 25 year period. Option four however, is assumed to have a value of only £375k resulting in an annual maintenance charge of £9.4k, representing £215.6k over the 25 year period or a NPV cash outflow of £146.4k. The difference of £439.9k in NPV terms is significant in size.

Whilst the initial valuation assumptions and their source are considered in more details in section 7.1.5, the cash flow model does not update the asset valuations for the capital expenditure incurred. For example, in option four it does not seem reasonable to assume that following capital spend of £2,350k on developing the building that the valuation should remain as £375k and the annual maintenance charge at £9.4k. In fact the Lambert Smith Hampton valuation reports a potential market value of £1,125k for the main mill alone, subject to planning.

The fact that annual rental rolls have been assumed to be £271k after the capital works would also indicate a market value far in excess of £375k. If the valuation of the site were valued at cost of £2,350k, which is a prudent assumption given the assumed rental rolls going forward, the annual maintenance charge would increase to £58.9k, totalling £1.35m over 25 years or £920k NPV cash outflow. The final NPV would be £2,140k representing a significant reduction in the financial value of the scheme from the reported £2,910k in table 5.

As there is such a disparity between options three and four in terms of the cash flows assumed for lifecycle maintenance, and the fact that neither options one, three nor four appear to account for the change in value of these assets following substantial investment, the driver behind this cost, it is difficult to assess the reasonableness of this cash flow. It would have been beneficial to state assumptions regarding the valuation post development or provide a comparison between the costs for assumed maintenance for these sites to actual costs incurred at similar developments within the Authority's portfolio.

A further anomaly is the fact that lifecycle maintenance costs are excluded completely from option two. In order to be consistent up until the time of sale an annual cost of £50.6k should have been incurred based on the valuation assumption of £2,025k. As the units were assumed to have been sold in year three the NPV cash outflow of this cost should have been £96.2k.

To summarise, the maintenance costs incorporated are inconsistently applied, contain arithmetical errors such as the misapplication of the discount rate and most importantly fail to consider the effect of capital spend planned for each site on the site's valuation. Failure to model the increase in site value after capital works are completed under option four, retention of St Ann's Mills, substantially increases the attractiveness of this option in financial terms. Taking this into account, although option four remains the best option in terms of NPV this is marginal as shown below in table 6.

No internal scrutiny of the DCF results relating to maintenance charges could be evidenced and no attempt was made to evaluate what the actual maintenance costs would amount to annually on a newly restored building. The 2.5% of cost is a standard assumption and could be an overestimation given that for a building in excellent condition internal repair responsibilities could be transferred legally to the tenant or the property could be subject to a substantial service charge. We also accept the Development Department's view that in the lead up to a major capital project the amount spent on maintenance of an asset would be scaled back to a minimum or ceased. However, this was not explained in either the Executive Board or supporting working papers and no audit evidence to substantiate actual maintenance costs was available at the time of our review.

Table 6

Option	Action	Net Present Value (£k) (adjusted table 5)	Impact of maintenance charge observations (£k)	Net Present Value (£k)
2	Sell both sites	2,040	(96)	1,944
4	Sell Abbey, retain St Ann's	2,910	(920)	1,990

7.1.5 Capital receipts

Capital receipts have been included in the DCF. This is one of the ways in which the Authority is able to generate its own capital resources for investment in new capital projects. It is a strategy which has been approved by the Executive Board in the Authority's capital strategy and asset management plan.

Option two assumes that the combined sales proceeds of St Ann's and Abbey Mills amount to £2,025k. These are based on independent valuation reports by Lambert Smith Hampton issued prior to the Executive Board report. The report values St Ann's Mill in industrial use subject to the tenancies at £375k and has been included in the DCF as an inflow of this amount. However, implicit in the valuation of £375k is assumption that the tenant of the main mill building who is liable under terms of the lease for 'imminent and essential works of repair identified by the condition survey of approximately £300k.' It became apparent that due to the poor financial position of the tenant occupying the main mill building as at 31 March 2003 the Authority would not be justified in pursuing a dilapidation claim to meet this funding requirement.

In terms of the DCF model, the fact that the tenant was not expected to undertake or pay for the repairs should have been shown as either a cash outflow of £300k in capital works to enable the full realisation of £2,025k or the more probable outcome, given capital constraints, lower sales proceeds of £75k for St Ann's Mills or £1,725k in total. The reduced value represents a material impact on option two.

Option three which also includes the disposal of St Ann's Mills, fails to account for the £300k required in repairs to the main mill to realise the full £375k sales proceeds, unless they are included within the £1,490k capital costs of the project. This appears unlikely and is not clear from the information at hand.

Option four, the preferred option, includes a significant capital receipt of £1,650k for the Abbey Mill site. This valuation was taken from the Lambert Smith Hampton report of 19 March 2004. However, the report contained several valuations depending on the planning permission obtained and the deemed the assumed usage of the site as depicted in table 7.

Table 7

Assumption on usage	**Valuation**
Commercial/Industrial use as existing	£300k
Mixed use incorporating such uses as craft shops, artist studios and living space	£450k
Residential use assuming existing access (without site B)*	£900k
Residential use assuming existing access (with site B)*	£1,250k
Residential use assuming new access (without site B) *	£1,000k
Residential use assuming new access (with site B)*	£1,650k

* - site B comprises a detached period building of approximately 4,000 square feet on a total site of 0.68 acres. Planning consent for residential use and the development of the land with the benefit of improved access of Abbey Road and also across the Mill Race has been assumed in the above valuations by Lambert Smith Hampton.

The valuation for Abbey Mill in the report of £1,650k is based on a number of assumptions which at the time of the Executive Board report had not been agreed with respect to site B.

However, vesting of land was raised as an issue in sections 5.2 and 6.6 of the Executive Board report. The inclusion of site B was also flagged as key to achieving an optimum redevelopment solution on this site. The fact that site B is an asset controlled by Leeds North West Homes Limited (ALMO) has been brought to the reader's attention as well as the impact that Neighbourhoods and Housing could have in terms of how a capital receipt of £650k in respect of this site is used.

In summary, the amounts included in the DCF model although based on an independent valuation, exclude significant amounts needed in terms of 'imminent and essential works' before the full value of the site can be realised. These amounts should be either realised as a cash outflow or netted off the gross sales proceeds recorded. Again, this would have a significant impact on the NPV results reported. Options two, three and four all assume that the disposal of either St Ann's, Abbey Mills or both and therefore include a capital receipts within the DCF model. However, there are a number of issues in respect of the amounts included within the model.

7.1.6 Future Rental Roll Assumptions

The assumptions made regarding the potential income available to the Authority following the completion of the capital works under options one, three and four is an important factor in the DCF model. As option two disposes of both sites rental income is no longer a factor under consideration in the option appraisal.

Option one assumes that initially rental rates will be maintained at £56k until the capital works have been completed. This assumption appears overstate the rental income as at the time of preparing the DCF the two sites had a combined annual rental roll of approximately £42k (table 1 section 4.3).

On completion of the capital works the rental roll is assumed to increase by £69k per annum (section 3.3 of the Executive Board report). This is not in line with the increase recognised in the DCF model where income increases from £56k to £112k an increase of £56k.

No detail regarding how the new rental roll figures were derived could be seen on the DCF model or in supporting working papers. Following completion of capital works and assuming the same average rental rate and occupancy could be obtained as for the rest of the Authority's portfolio of SIUs (table 1), the annual rental that should be attainable for a combined area of 51,137 square feet should be approximately £181k.

This is materially more than has been reflected in the DCF forecast. If the rental income were adjusted to reflect the apparent over representation in periods one to five and under estimation in period six onwards the effect would be an increase in rental over 25 years of £1,310k and an increase in the NPV of this option of £762.5k.

Option three assumes static rental income of £20.5k for years one and two, increasing to £37.3k between periods three and six and finally realising income of £74.7k from period seven onwards. These assumptions appear reasonable as given the area of Abbey Mills at 22,952 square feet and applying the average SUI rental and occupancy rates of £4.60 per square foot and 77% respectively from table 1 would give a maximum rental yield of £81k. This is not significantly different from the amounts assumed.

The recommended option four in the Executive Board report assumes that rental incomes will increase from £21.5k, which is slightly higher than the current amount being received of £19k to £271k per annum from year five onwards. This dramatic increase of 1,260% is presumably based on the assumption that the usage of the site will change from SIUs to managed work spaces.

The Executive Board report states in section 3.6.1 that option four 'allows significant remodelling/refurbishment leaving the Council with modern appropriate units.' Section 4.3 also states that St Ann's Mills will be subject to remodelling 'to provide smaller floor plate managed workspace more appropriate to the needs of small businesses and the aspirations of the Development Department.' The intentions of the site usage at St Ann's Mills are not clear in the Executive Board report, as advantages of option four also in section 3.6.1 include 'accommodating all tenants intending to remain at either of the two sites.' If the usage were to change from SIUs then St Ann's Mill may become unsuitable for remaining tenants of Abbey Mills. This suggests continued use as SIUs whereas the rental income assumptions suggest otherwise. No where within the report does it specifically state that the usage will change from SIUs to managed work space provision.

Given that there are no workings within the DCF showing how the £271k rental per annum has been derived it is assumed that they have been taken from the Lambert Smith Hampton report. This report considers £13.50 per square foot is achievable giving an annual rental roll of £252k on the main mill building which with an additional floor as detailed in section 3.6.1 would represent 18,000 square feet.

The balance of the £271k, £19k is assumed to be received from the other units at St Ann's Mills. The assumptions made regarding the potential rental rates as managed work space accommodation have been derived using typical office rental levels within the district which range from £12 to £16.25 per square foot. Although, £13.50 appears to a fair estimate and is taken from an independent source, no indication of the level of demand for such accommodation has been modelled and it is no reference has been made to other Authority owned managed work space accommodation and rental rolls attained as a means of comparison.

Again, there is a lack of clarity regarding the assumptions employed to derive the potential rental income of these sites and their intended use within the Executive Board report and the working papers to supporting the DCF model. The Executive Board report also failed to model the risk that occupancy levels varied from maximum levels through sensitivity analysis in the DCF model.

7.1.7 Summary of DCF Findings

Through reviewing the key assumptions contained within the DCF model it was apparent that whilst there were clearly significant errors such as the mathematical inaccuracies, there were also inconsistencies and a lack of clarity between the narrative in the Executive Board report and assumptions within the DCF. Whilst the Development Department were able to provide explanations to some of the issues raised, we were rarely able to substantiate assumptions to explanatory working papers or third party evidence.

When combined, although the above observations result in the financial information reported in the Executive Board being incorrect and potentially misleading, we recognise that if we adjust the option appraisal for our findings, the option championed by the Executive Board report still results in the highest NPV result. The Executive Board report also states that the DCF result 'supports the choice of option four' which suggests the decision matrix (appendix one) and wider consideration of non-financial aspects of the options available were the key drivers behind the Development Department's recommendation.

Appendix 1

Summary of Options

Appendix 1 – Summary of Options

Budgets/Objectives	Retain both sites	Sell both sites	Sell St Ann's Mills, retain Abbey Mills	Sell Abbey Mills, retain St Ann's Mills
Asset management budget available (£000s)	200	-	200	200
Capital receipts available (£000s)	-	2,025	375	1650
Contribution to capital programme (£000s)	-	2,025	-	-
Backlog maintenance to be addressed (£000s)	1,060	-	626	433
Sufficient budget to cover backlog maintenance on retained properties	N	Y	N	Y
Sufficient budget to cover remodelling/refurbishment and DDA issues on retained properties	N	Y	N	Y
Sufficient budget to cover public realm works at St Ann's Mills	N	Y	N	Y
Sufficient budget to cover public realm works at Abbey Mills	N	Y	N	Y
Likely that both sites will contribute to the physical regeneration of Kirkstall	N	Y	N	Y
Retention of sufficient quantity of Council SIU in Kirkstall	Y	N	Y	Y
Retention of sufficient quality of Council SIU in Kirkstall	N	N	N	Y
Rent roll protected	N	N	N	Y
Guaranteed protection of existing tenants	Y	N	Y	Y
Retains both sites in Council control	Y	N	N	N